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HORIZONS FOR GROWTH
Annual Report 2004



HILLSBOROUGH
Resources Limited

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Dear fellow shareholders,

The theme of this year's annual report is 'Horizons for Growth'. The picture on the front cover of the report is of one of our new coking coal properties in the Northeast of British Columbia which we have named Five Cabin. It is one of six large properties we control in the area and which are collectively referred to as the Murray River Group. These properties, together with another five which we acquired at the same time, truly represent Hillsborough's horizon for growth.

That is our future, and we have much work to do before we start to reap the rewards of our investment in those properties. I am happy to report that there has been much interest shown in these Northeast properties. From Japanese trading companies to Chinese steel mills, they all recognise the benefit of a stable source of quality metallurgical coal with excellent reserves and an under-utilized transportation corridor ready to get the coal to those hungry markets. I am very confident that we will finalize marketing and financing arrangements with a number of these parties, enabling us to bring this coal to production while limiting the need to resort to further equity finance.

But let us get back to the present, for it too is exciting.

During 2004 we acquired the Bingay Creek coking coal property in Southeast British Columbia's Elk Valley region. Initial drilling in the latter part of the year confirmed that we had acquired a property with the potential to be a mine of perhaps 500,000 tonnes annual output. Subsequent drilling which we completed in early 2005 has shown that the property holds coal resources even greater than expected. As a result, we are now investigating plans to develop Bingay Creek into a larger mine with an output of up to 1 million tonnes annually. As with other Southeast mines, we were heartened by CP Rail's recent announcement of a substantial investment in their rail system to enable them to alleviate much of the congestion presently occurring on their line.

In the latter half of 2004 we had our first discussions with the owner of a mine located near Crossville, Tennessee that had reached the end of its life as an open-cut operation. The geologic situation there called for an underground mine, and underground mining is something at which Hillsborough excels. In February 2005 we completed the transaction, and in April 2005 the first coal, from the box cut taken as we developed the underground mine, began to flow from the wash plant to the clean coal stockpile ready for shipping to market. The start-up of this operation has been a truly amazing performance by all concerned. We offer a warm welcome into the Hillsborough family to Mike Webster, who's joined us as mine manager, and the rest of his Crossville team.

I cannot close off this letter without a few words about our flagship mine, Quinsam. 2004 saw a real firming in international thermal coal prices, and this encouraged us to finalize the acquisition of the Middle Point coal terminal and barge-loading facility just north of Campbell River, B.C. The \$3.7 million cost replaced a user fee whose level was based on the international price of coal. At today's prices that would have meant a user fee of \$2 per tonne, or a little over \$1 million per annum, money which now stays with Hillsborough and translates into a cash payback of a little over three years.

In response to the surge in demand for thermal coal both internationally and domestically, Quinsam increased its production rate by over 50% during 2004, accomplishing this with a combination of new equipment and additional manpower. Our new people are young, some just out of high school. And while keen and eager to learn all the nuances of underground coal-mining, all have been inculcated with the Quinsam mantra of "Safety is Job #1". As a result, I am happy and so very proud to report that Quinsam was earlier this year presented with the B.C. small underground mine safety award for the sixth consecutive year.

In closing, I would like to thank all our directors for their ongoing wise counsel, and especially Tom Lindsay who is stepping down from the board to focus on his other business obligations. In his place, the board has nominated Nick Geer, a well-known and highly-respected Vancouver businessman. Earlier in 2005, we also welcomed Barry Irvine to the board. Barry was, until 2003, the President & CEO of Lehigh Northwest Cement, and brings a wealth of knowledge of the cement industry to our board.

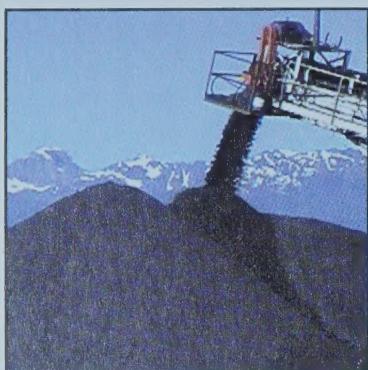
And of course I would be remiss in not thanking you, the Hillsborough shareholders, for your patience in what have sometimes been very trying times. Your support WILL be rewarded.

Yours very truly,



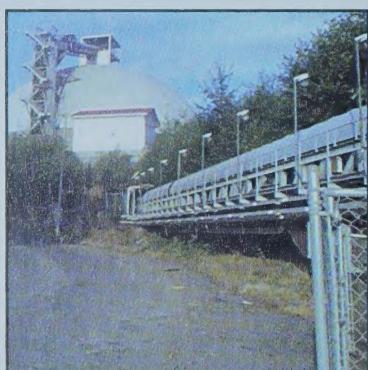
David J. Slater
President & CEO

Hillsborough Resources Limited is a coal mining company that operates the Quinsam coal mine in Campbell River, British Columbia, and the Crossville coal mine in Tennessee which is currently being brought into commercial production. We are developing substantial metallurgical coal properties near Tumbler Ridge in Northeast British Columbia, as well as the Bingay Creek metallurgical coal project in the Elk Valley region of Southeast British Columbia.



Quinsam Coal Mine

Located near Campbell River, British Columbia, Quinsam is an underground mine producing thermal coal for the local and west-coast US markets as well as for shipment into the international marketplace. Employing over 80 people and holding one of the best safety records of any mine in Canada, Quinsam has been the company's flagship operation. Quinsam sold 493,000 clean tonnes of coal in 2004, and in 2005 should produce 520,000 clean tonnes for market.



Middle Point Barge Facility

The large majority of the coal produced from the Quinsam mine is shipped through the Middle Point coal terminal and barge facility, located near Campbell River. In April 2004, your company acquired Middle Point from the B.C. Transportation Finance Authority, enabling us to lower our transportation costs and securing greater control for us over a key component of Quinsam's transportation process.

Quinsam Coal Bed Methane

During 2004, your company successfully reached an agreement with the provincial government to secure the title rights to coal bed methane in our freehold coal beds near Quinsam. We are now working with an operating partner on preparing an exploration strategy and obtaining permitting for exploratory drilling, with a view to establishing the potential for gas production from these properties.

MIDDLE POINT
BARGE FACILITY

QUINSAM
COAL MINE

B.C.

ALB.

**NORTHEAST
PROJECTS**

**BINGAY CREEK
PROJECT**

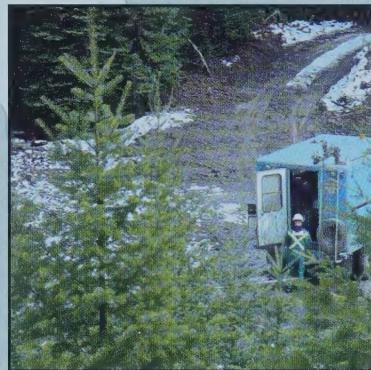
Northeast Project

In early 2005, Hillsborough acquired 11 coal properties in the Tumbler Ridge area of Northeast British Columbia. The largest of these, the Five Cabin, has the potential to be one of the largest single open-pit deposits in the Northeast coal fields. Drilling to delineate resources on the properties commenced in March 2005, and exploration and development will continue through the year.



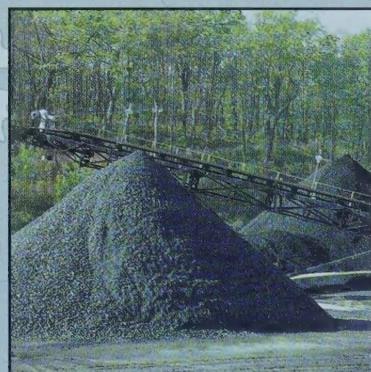
Bingay Creek Project

The Bingay Creek metallurgical coal property was acquired during 2004, and by the end of the year drilling had delineated over 7.5 million tonnes of measured and indicated coal resources and a further 2.7 million tonnes of inferred resources. In January 2005, a small mine permit application was submitted, and we hope to have the permit issued by mid year to enable us to commence putting a small open pit mine into production.



Crossville Coal Mine

In February 2005, your company completed the purchase of coal leases, a coal preparation plant and various pieces of surface mining equipment near Crossville, Tennessee. Formerly a surface mine, Hillsborough immediately commenced opening an underground mine on the property. A box cut is being taken in the coal seam, creating a face from which the underground mine will be developed, and coal from the box cut is being sold into the regional market commencing in May. We anticipate commercial production to commence from the underground mine during the third quarter of 2005.



**CROSSVILLE
COAL MINE**

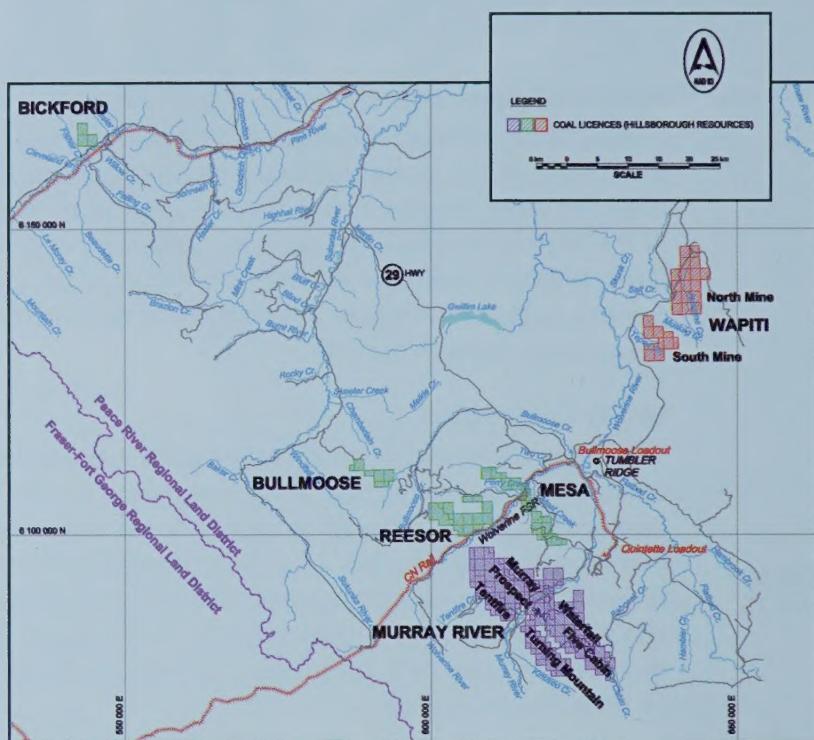
TENNESSEE

The Northeast Project

In early 2005, Hillsborough completed the acquisition of a group of 11 coal properties located in the area of Tumbler Ridge in Northeast British Columbia. The properties primarily contain metallurgical coal from both the Gates and Gething formations, with some including PCI and thermal coals as well. The most significant of the properties is the Five Cabin, containing a large synclinal structure, which along with five other of the properties comprises the Murray River group.

Five Cabin Syncline

Located 15 kilometres southwest of the Quintette mine site, the Five Cabin property is close to railhead and easily accessible through the Murray River valley by all-weather gravel roads. Historical estimates filed previously by Denison Mines Limited in the 1970's report resource estimates of 450 million tonnes of coal in the Gates formation and 160 million tonnes of coal in the Gething formation, based on cumulative coal seam thicknesses of 15.2 metres in the Gates formation and 4.6 metres in the Gething. While we consider these historical estimates to be relevant to the property, they must be qualified as they have not been confirmed by Hillsborough and the estimation procedures and classification criteria used may not have been in accordance with those now prescribed under National Instrument 43-101. Drilling on the property commenced in March 2005 to confirm and delineate the resource, and we intend to issue a confirmed resource estimate in mid 2005.



Crossville Coal Mine

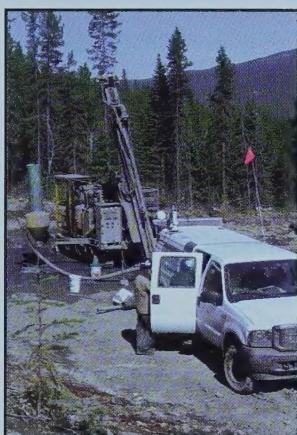
A former surface mining operation, Hillsborough purchased the Crossville property in February 2005 and we immediately started the process of following the coal seam underground. A box cut is being excavated in the coal seam, establishing a face from which ramps for the underground operation will be taken. Coal taken from the box cut process is being washed through the coal preparation plant included in the assets purchased, and will be sold into the regional market starting in the second quarter of 2005.



We expect to recover a significant portion of the upfront development costs required to bring the underground mine into production from the revenue generated by sale of coal recovered from this box cut process. We expect the Crossville underground mine to enter commercial production during the third quarter of 2005.

Additional Properties.

The Five Cabin property is one of six Hillsborough has acquired which together comprise the Murray River Group. These are adjacent properties with known existence of Gates and Gething metallurgical coals and identified general geological structures. The resources developed within this group could be processed through plant facilities centered on the Five Cabin, resulting in what could become one of the most significant mining projects in the province. The remaining five properties acquired by Hillsborough are also in the same general region, containing metallurgical, PCI and thermal coals and in varying stages of resource development. They include the Reesor and Mesa properties, containing Gates and Gething coking coals and favourably located adjacent to the CN rail line through the Wolverine River valley. The development prospects for each of these additional properties will be investigated and furthered over the coming two years.



Development Plan for 2005

Our initial focus on the Northeast Project is to establish coal resource estimates for the major properties, particularly the Five Cabin. Drilling was commenced in March 2005 and is expected to continue for much of the balance of the year. We will be developing resource estimates during 2005, and will proceed from there to develop pre-feasibility plans for mining operations. A number of development scenarios are under consideration, not only for high-volume mining but for alternatives that would enable Hillsborough to generate more immediate scaled production.

Expressions of interest have been received from a number of international parties regarding marketing rights to the metallurgical coal production from the Northeast properties, including end-users and trading companies. Discussions with such parties will continue as we develop markets for the coal in connection with establishing the feasibility of mining operations.

The development of the Northeast Project and the Five Cabin property will be a primary focus for Hillsborough over the coming year. The value addition that will come from successfully demonstrating the extent of the Northeast coal resources and the feasibility of mining them is a key component to our strategy to substantially grow the capitalized value of Hillsborough as a company.

Producing thermal coal, the Crossville mine will service power producing customers in the Tennessee regional market. We have entered into a multi-year agreement to supply coal to nearby power plants owned by the regional power utility, near enough to deliver by truck, and year on year expect to deliver approximately two thirds of the Crossville production under that agreement.

The remaining one third production will be held available for delivery to other regional customers on shorter term or spot market arrangements.

We expect the Crossville mine to begin making a positive contribution to earnings in 2005, and to achieve its full targeted production rate of 600,000 short tons of clean coal per year during 2006.



**Management's Discussion and Analysis of
Financial Condition and Results of Operations****For the Year Ended December 31, 2004**

This Management's Discussion and Analysis ("MD&A") has been prepared as at March 23, 2005, and should be read in conjunction with the audited consolidated financial statements with accompanying notes of Hillsborough Resources Limited (the "Corporation") for the year ending December 31, 2004 which have been prepared in accordance with Canadian generally accepted accounting principles. All amounts are reported and measured in Canadian dollars.

This MD&A contains information that is forward looking in nature and as such actual results may differ materially from the expectations of management. Events which may cause these results to differ from those results identified herein may include, but are not limited to, unexpected increases in the costs of producing coal, interruptions in the ability of the Corporation to produce coal from any of its mines, changes in international coal or transportation markets, a rapid appreciation of the Canadian dollar versus the US dollar and a fundamental slow-down in the North American or Asian economies.

Selected Annual Information

Selected annual information from the Corporation's three most recently completed financial years is summarized as follows:

	2004	2003 (restated)	2002 (restated)
Coal revenue (\$)	23,395,086	13,467,011	17,987,444
Contribution from sales (\$)	4,166,631	2,004,291	2,200,491
Net earnings (\$)	1,811,056	874,336	(233,608)
Earnings per share — basic	0.06	0.03	(0.01)
Earnings per share — diluted	0.05	0.03	(0.01)
Total assets (\$)	27,294,492	16,984,785	17,322,714
Total long-term financial liabilities (\$)	—	18,127	27,476
Coal production (tonnes raw)	589,381	454,058	519,396
Coal sold (tonnes clean)	492,859	284,371	395,619
Coal revenue per tonne	47.47	47.36	45.47
Production cost of coal sold per tonne	39.01	40.31	39.90

The Corporation did not declare any dividends during the three most recently completed financial years.

Overall Performance and Significant Developments

The Corporation's net earnings for 2004 increased substantially over 2003, from \$874,336 or \$0.03 per share to \$1,811,056 or \$0.06 per share. A primary reason for these higher earnings was an increase of 73% in the volume of coal sold over 2003, allowing the Corporation to realize a stronger contribution after its production costs against its fixed overheads. Other notable factors affecting 2004 net earnings included approximately \$394,000 in gains from sales of surplus equipment and supplies inventory, offset somewhat by a \$346,030 write-off of costs associated with the Quinsam power project. Net earnings for 2003 were impacted by a temporary six week suspension of operations at the Quinsam mine that did not occur in 2004, partially off-set by a gain in 2003 of \$682,557 from the reversal of certain unsecured creditor liabilities.

The Corporation's net working capital at December 31, 2004 was \$8,966,011 compared to \$6,143,356 at the end of 2003, an increase of \$2,822,655, and the Corporation had no long term financial debt at December 31, 2004. The Corporation's non-financial asset retirement obligation at December 31, 2004 was \$1,092,896, increasing during the year from \$737,689 at the end of 2003 in part because of normal accretion but primarily because of the obligation arising from the acquisition during 2004 of the Middle Point barge loading facility located near the Quinsam coal mine.

**Management's Discussion and Analysis of
Financial Condition and Results of Operations**

As noted, during 2004 the Corporation acquired the Middle Point barge loading facility located on Vancouver Island near the Quinsam coal mine. Historically, the majority of Quinsam's coal production has been shipped through this facility, and the Corporation paid user fees to do so. The Corporation has acquired the facility for a cost of \$3.7 million, with the intent of lowering its transportation costs as well as securing greater control over a key component of its transportation process.

During 2004, the Corporation entered into an option agreement to acquire a 100% interest in the Bingay Creek property, an exploration and development coking coal property located in Southeast British Columbia in the Elk Valley region. The Corporation paid \$120,000 to the optionors in 2004 and must incur a minimum \$500,000 in exploration and development expenditures in respect of the property by August 1, 2007. The Corporation expects it will have completed this work obligation by mid 2005. The optionors have been granted royalties in respect of washed coal ranging from \$1 to \$2.75 per tonne sold and royalties in respect of raw coal ranging from 2% to 4% of sale proceeds, depending on the type of coal and the area of the property from which it is produced. One of the optionors is, and was at the time the agreement was entered into, an employee of the Corporation.

During 2004, a geological field mapping and exploration drilling program was completed on one portion of the property, and a technical report was prepared in accordance with National Instrument 43-101 ("NI 43-101") identifying a total of 7.56 million tonnes of measured and indicated coal resources and a further 2.68 million tonnes of inferred coal resources. Background environmental studies and engineering work was undertaken as well, and in January 2005 a small mine permit application was submitted to the British Columbia Ministry of Energy and Mines.

Results of Operations — Full Year

During 2004, the Corporation had one operating coal mine, being the Quinsam coal mine located on Vancouver Island, British Columbia. During 2004, raw coal production from the Quinsam mine increased by 30%, partly because production was suspended for six weeks during 2003 and no shut-down occurred in 2004, and partly because the Corporation increased production throughput at the mine during 2004. To sustain the increased production rate, the Corporation hired and trained approximately 15 new miners in late summer and early fall 2004, increasing the workforce at the Quinsam mine to approximately 80 people and reducing the average age of the mine's workforce from 51 to 37. While production inefficiencies were experienced for approximately two months as the new miners were trained, by December 2004 and into 2005 increased production rates and lower per-tonne production costs were being consistently achieved.

As of the end of 2004, the Quinsam mine was operating at an annualized production rate of approximately 765,000 raw tonnes, or 520,000 clean tonnes, per year. The Corporation does not accumulate significant coal inventories for speculative sales, and accordingly raw and clean coal production rates are regularly adjusted to respond to pricing and demand changes in the international short-term delivery contract market and to meet the requirements of its longer-term domestic contract customers.

Demand for Quinsam's coal was strong during the year, both in the international short-term delivery contract market and the longer-term domestic contract market, and the contribution from this higher sales volume had a substantial positive impact on the Corporation's net earnings. Average revenue per tonne of coal sold in 2004 was \$47.47, essentially unchanged from \$47.36 in 2003, a function of higher international market prices offset by a shift in volume mix under various domestic contracts carrying different pricing mechanisms and the impact of a stronger Canadian dollar on sales where prices were denominated in US dollars. Total volume of coal sold, however, increased over 2003 by 73%, resulting in an increase in revenues to \$23,395,086 in 2004 from \$13,467,011 in 2003. The contribution margin on coal sales in 2004 was 17.8% in 2004 versus 14.9% in 2003, primarily as a result of an approximately 3.2% decrease in average production costs, including transportation as the effect of the acquisition of the Middle Point facility was realized.

**Management's Discussion and Analysis of
Financial Condition and Results of Operations**

Amortization and depletion recorded in 2004 was \$994,065. This included amortization of general and administrative assets of \$32,256, amortization and depletion of production assets of \$890,884 attributable to coal sold which is included in the production cost of coal sold, and \$70,925 of production asset amortization and depletion which was included in the cost of year-end inventory. The increase over the total 2003 expense of \$643,906 was due to the increase in the Corporation's property, plant and equipment base, primarily as a consequence of the acquisition of the Middle Point barge facility and certain non-recurring equipment purchases and additional mine development costs incurred at Quinsam. Selling, general and administrative expenses totaled \$2,026,179 in 2004 versus \$1,692,686 in 2003, with the increase attributed primarily to bonuses awarded to staff in the fourth quarter of 2004 in light of the Corporation's performance in the year. Certain expenses such as consulting and professional fees increased as well in connection with the increased corporate activity during the year.

Under other income and expense items, the Corporation has recorded a charge in 2004 of \$346,030 from writing off its investment in the Quinsam power plant project, as a consequence of the project proposal being rejected by the B.C. Hydro. Additional significant items included in other income and expense for 2004 include a gain of \$316,320 on the sale of an item of used equipment which had been included in the financial statements in assets held for resale, other gains on sales of surplus equipment and mining supplies totaling \$77,369, interest expense of \$50,759 which includes \$24,885 of financing costs related to the exercise of certain warrants, and a foreign exchange loss of \$136,515. Significant items during 2003 included a gain of \$682,557 from the reversal of unsecured creditor liabilities at Quinsam under a court-approved creditor order issued in 2000, and within other income and expenses equipment rental income of \$64,177, sales tax refunds on safety equipment of \$76,766, and an expense of \$60,740 relating to corporate restructuring and the temporary shut-down effected during 2003.

With respect to the Corporation's resource properties, the main property under exploration and development during 2004 was the Bingay Creek coking coal property. During the year, a drilling program was undertaken resulting in a technical report delineating 7.56 million tonnes of measured and indicated resources and a further 2.68 million tonnes of inferred resources. In January 2005, a small mine permit application was submitted to the British Columbia Ministry of Energy and Mines, and the Corporation hopes to be able to receive the issued permit sometime in the second quarter to enable it to commence putting a small 250,000 tonne per year open pit mine into operation. Significant risk factors that may affect the ability of the Corporation to put the property into operation include the risk that the permit may not be issued or may not be issued in the time frame the Corporation is anticipating, the availability of mining equipment and the availability of transportation, particularly rail, for the coal product from the mine to a port facility.

The Corporation continues to work with its operating partner, Texas Canadian Venture Inc., on preparing an exploration strategy and obtaining permitting for exploratory drilling on the coal bed methane in its freehold coal beds near Quinsam. During 2004, agreement was reached with the British Columbia government confirming the Corporation's title to coal bed methane in its freehold coal beds.

Results of Operations — Quarter ended December 31, 2004

During the fourth quarter of 2004, coal revenues were \$4,929,589 on sales of 110,567 clean tonnes, for an average revenue per tonne of \$44.58. Average revenue per tonne was below the average for the full year of \$47.47 as there were no sales into the international market during the quarter. Production costs averaged \$38.43 per tonne of coal sold in the quarter compared to \$39.01 for the full year, similarly lower as no international shipments during the quarter resulted in lower transportation costs. Net earnings for the quarter was \$172,645.

Summary of Quarterly Results

Key financial and operating statistics for the most recent eight quarters is presented below:

Period	Sales (\$)	Sales (t)	Rev/t	Net Earnings	Prod'n Cost	Cost/t	Basic EPS(\$)	Dilut'd EPS(\$)
2003-Q1	3,236,325	65,523	49.39	(48,232)	2,909,341	44.40	0.00	0.00
2003-Q2	4,471,710	99,329	45.02	(71,758)	3,913,051	39.39	0.00	0.00
2003-Q3	2,343,081	48,398	48.41	586,361	1,978,656	40.88	0.02	0.02
2003-Q4	3,415,895	71,121	48.03	407,965	2,661,672	37.42	0.01	0.01
2003 Total	13,467,011	284,371	47.36	874,336	11,462,720	40.31	0.03	0.03
2004-Q1	6,719,374	140,545	47.81	569,022	5,846,954	41.60	0.02	0.02
2004-Q2	7,641,735	150,462	50.79	953,740	5,774,271	38.38	0.03	0.03
2004-Q3	4,104,388	91,285	44.96	115,649	3,357,688	36.78	0.00	0.00
2004-Q4	4,929,589	110,567	44.58	172,645	4,249,542	38.43	0.01	0.00
2004 Total	23,395,086	492,859	47.47	1,811,056	19,228,455	39.01	0.06	0.05

Note that all quarterly figures for production cost of coal sold have been restated for the effect of the new classification policy adopted in 2004 whereby amortization and depletion costs applicable to production sold during a period are included in production costs.

Net earnings during first and second quarters of 2004, and the volume of coal sales in those quarters, were positively impacted by the sale of coal shipments into the international short-term delivery contract market.

The reader should be aware that while past history may be reflective of certain trends, it is not an overly reliable predictor of the future. This is because the interrelationship among production volumes, production costs, the mix between spot and contractual sales, and the prevailing spot price and foreign exchange rates will all interact to result in a unique financial performance for the period being considered.

Outlook

In February 2005, the Corporation completed the acquisition of certain coal leases and mining assets located near Crossville, Tennessee. The vendor of the leases and equipment had previously operated a surface mine on the property and by late 2004 had exhausted the resource economically mineable from surface. The Corporation has acquired the leases with the intent of bringing an underground coal mine into operation on the property. The consideration paid by the Corporation, including costs, aggregated \$1,338,876, and the appraised and estimated in-use value of the mining assets acquired net of liabilities assumed was approximately \$2,790,000. Included in the assets purchased was a fleet of surface mining equipment which the Corporation immediately sold to a third party for cash proceeds equal to its fair value of \$2,685,636. Of these proceeds, \$1,517,554 was applied to certain of the liabilities assumed, and the balance will be applied against other assumed liabilities and otherwise applied to the development of the underground mine. While the Corporation has historical reserve estimates pertaining to the property, these estimates are not verifiable to the extent required under NI 43-101. The Corporation is currently carrying out a drilling program on the property to delineate the reserves to the standard required under NI 43-101.

**Management's Discussion and Analysis of
Financial Condition and Results of Operations**

In January 2005, the Corporation entered into a letter of intent to acquire a group of coal resource properties located in Northeast British Columbia near Tumbler Ridge, and in March 2005 the final terms of the transaction were agreed and the acquisition was closed. The group includes 11 properties, eight of which are coking coal properties, two of which are coking coal and PCI (pulverized coal injection) properties and one of which is a thermal coal property. The consideration to be paid for the properties by the Corporation comprises a mixture of cash and shares, with \$400,000 paid on closing and the remaining consideration paid over time upon the achievement of various milestones in the development of the properties, described as follows.

The most significant of the properties is known as the Five Cabin, a coking coal property, and consideration to be paid by the Corporation in respect of it comprises 800,000 shares upon the preparation of a coal resource estimate report; \$500,000 and 1,000,000 shares upon preparation of a pre-feasibility study; \$500,000 and 1,000,000 shares upon preparation of a feasibility study; and \$1,000,000 and 1,500,000 shares upon commencement of commercial production from the property. Consideration to be paid for each of seven additional coking coal and PCI properties comprises shares issuable upon preparation of a coal resource estimate report and upon preparation of a pre-feasibility study in respect of the property, ranging from 4,000 to 5,000 shares per 100,000 tonnes of coal resource identified, with a minimum of 10 million tonnes of resource required to trigger consideration payment.

For the one thermal coal property, the Corporation must issue 225,000 shares on delivery of a coal resource estimate report and a further 625,000 shares on preparation of a pre-feasibility study, and an additional 1,250 shares for each 100,000 tonnes of resource identified in excess of 20 million tonnes. And for one coking coal and PCI property, the Corporation must issue shares upon preparation of a coal resource estimate report and upon preparation of a pre-feasibility study in respect of the property, ranging from 3,000 to 5,000 shares per 100,000 tonnes of coal resource identified depending on whether the resource is coking coal or PCI or thermal coal, with a minimum 5 million tonnes of resource required to trigger consideration payment.

Various time limits apply within which the Corporation must achieve the set milestones, but the Corporation has the right to extend those time limits on a property basis by making certain cash payments. At all times the Corporation has the right to deliver any of the properties back to the vendor, in which case no further consideration or milestone obligations will be owing by the Corporation in respect of such property. All properties are subject to a 1% mine-gate royalty in favour of the vendor. Upon closing of the acquisition of these properties, the primary vendor has been hired by the Corporation in a senior management capacity.

In 2005, the Corporation's business activities will be significantly different than what they have been in prior years. While the Quinsam coal mine will continue in operation, the Corporation will be bringing its second operating mine into production at Crossville, with commercial production slated to have commenced by summer 2005. A production level of 600,000 short tons of clean coal per annum is targeted at Crossville by 2006, more than doubling the Corporation's current output. Significant exploration and development activities will be required to advance the Corporation's new Northeast British Columbia coal properties, with the nature and extent of those activities dependent upon the results obtained as the activities proceed. Development activity is expected to continue as well at the Corporation's Bingay Creek coking coal resource property in Southeast British Columbia.

Industry forecasts with respect to coal prices in general indicate that the strong prices for both thermal and coking coal seen over 2004 will continue through 2005 and into 2006. A significant portion of the coal production from the Quinsam mine is sold under long-term one to two year contracts, and as those contracts have renewed the average prices under them have been increased to reflect the higher spot prices. The Corporation has successfully renewed for terms of one to two years all domestic sales contracts that expired during 2004. Average revenue per tonne of coal sold from Quinsam overall is accordingly expected to be higher in 2005, depending on the extent to which sales are made into the international market. Demand for the Quinsam coal is expected to remain strong, and the Corporation anticipates maintaining current production levels through at least 2005.

Management's Discussion and Analysis of Financial Condition and Results of Operations

Similar coal pricing and demand strength is anticipated for the regional market served by the Crossville mine. Risks specific to the Crossville project that might affect the Corporation's ability to profit from that strength are primarily associated with the start-up of the mine, including uncertainty as to actual mining conditions and the impact they may have on projected mining costs, ability to acquire on a timely basis the equipment necessary to operate the underground mine at full planned capacity and the availability of a suitably trained labour force.

Liquidity

At December 31, 2004, the Corporation had cash on hand of \$6.9 million compared to \$1.4 million at December 31, 2003, an increase of \$5.5 million. This was mainly due to a share financing completed on December 30, 2004 generating net proceeds of \$6,033,745. The Corporation's net working capital at December 31, 2004 was \$8,966,011 compared to \$6,143,356 at December 31, 2003. Coal inventories were reduced from \$3,945,054 at December 31, 2003 to \$1,245,052 at December 31, 2004, though coal inventories can fluctuate significantly during the year in the normal course depending primarily on whether the Corporation is building inventory in preparation for a shipment into the international market.

The Corporation's operating results from the Quinsam mine have been strong through 2004, and cash generated from operating activities has been more than sufficient to cover the normal replacement capital needs. Cash generated from the sale of the built-up inventory on hand at December 31, 2003 was used to finance the Corporation's property, plant and equipment expenditures beyond the normal replacement needs of Quinsam, the most significant components of which were the acquisition of the Middle Point barge facility for approximately \$3.7 million, a continuous miner rebuild costing approximately \$0.9 million and additional underground development costing \$0.5 million.

For 2005, the cash flows from operations at the Quinsam mine are expected to continue to be more than sufficient to cover the normal replacement capital needs. The Corporation will be making additional capital expenditures, however, in connection with bringing the Crossville mine into production, undertaking exploration and development programs on the Northeast British Columbia coal properties and furthering the development of the Bingay Creek coal property. Cash flows from operations are not expected to be sufficient to cover these additional capital requirements, and to achieve its objectives with respect to these properties the Corporation will be required to raise additional capital.

The following table identifies the commitments that the Corporation has entered into under various operating leases for equipment and office premises:

Year	Operating Leases
2005	287,592
2006	74,657
2007	17,374
2008	5,853

The Corporation also has conditional commitments with a third party trucking company for which the Corporation pays a per tonne fee based upon the monthly volume of coal transported to the Middle Point facility.

Capital Resources

Replacement capital spending at the Quinsam mine in 2004 was approximately \$3.7 million versus \$1.4 million in 2003, with the increase due to certain expenditures that are not regularly recurring including \$0.9 million for a continuous miner rebuild and \$0.5 million for additional underground development as noted above. Regularly-recurring replacement capital expenditures in 2005 are expected to be generally similar or less than those expended in 2004.

**Management's Discussion and Analysis of
Financial Condition and Results of Operations**

Capital expenditures to bring the Crossville mine into operation are broadly estimated to be in the range of \$5 million to \$6 million, to be incurred over the course of 2005 and early 2006. Capital expenditures relating to the exploration and development of the Northeast British Columbia coal properties will depend on the successful progression of those exploration and development programs, but during 2005 are expected to range from a minimum of approximately \$2 million to as much as \$5 million. Capital expenditures to develop the Bingay Creek property during 2005 and 2006 will also be significant when the Corporation commences the process of bringing the property into operation, with current estimates ranging as high as \$7 million over the two year period.

The advancement of each of these projects remains subject to investment approval by the Corporation and may or may not in fact proceed on the basis described, however the potential capital needs of the Corporation should all of the projects be advanced are significant and the cash flows from the Corporation's operations will not be sufficient to cover those needs. To fund its capital requirements, the Corporation may seek debt financing, particularly with respect to equipment needs in connection with the Crossville operation or Bingay Creek, or equity financing or a combination thereof. The Corporation is in the process of identifying debt finance sources that may be suitable for its coming needs, but has not yet entered into any agreements in respect thereof.

Off-Balance Sheet Arrangements

Other than the operating leases referred to above, the Corporation has no off-balance sheet arrangements.

Related Party Transactions

During 2004, the Corporation has paid \$383,560 to two companies which are related to different directors of the Corporation. The payments were made for legal services and for coal trucking and crushing services, at what the Corporation considers to have been fair market rates. Payments to related parties during 2003 totalled \$289,447, in respect of legal services, coal trucking and aggregate crushing services and engineering consulting services on the power project.

With respect to the Bingay Creek property agreement, one of the optionors is, and was at the time the agreement was entered into, an employee of the Corporation. With respect to the Northeast British Columbia coal properties, upon closing of their acquisition the primary vendor has been hired by the Corporation in a senior management capacity.

Critical Accounting Estimates

The most critical accounting estimates made involve evaluating the carrying value of property, plant and equipment and estimating asset retirement obligations including future environmental obligations and estimating site restoration costs.

Property, plant and equipment is carried at cost less accumulated depreciation and write downs. At least annually, management estimates the undiscounted future cash flows expected to be generated from those assets. If this estimate is less than the carrying value of property, plant and equipment, an appropriate charge to earnings is made to write the impaired assets down to the present value of those estimated future cash flows. The estimate of future cash flow requires estimates of factors such as the mineability and cost of coal reserves and resources, future coal prices, foreign exchange rates and the consumption patterns of critical customers. It also requires estimates to be made as to the quantity and quality of coal reserves and resources available to be mined.

Management must also estimate the cost of asset retirement obligations. These estimates are based upon internal engineering studies which are reviewed by external consultants. These estimates rely on future labour and equipment operating costs and they assume that there will be no major change in applicable environmental laws and regulations. Under the accounting standards applicable to asset retirement obligations, the Corporation must make estimates of future inflation rates and the Corporation's risk adjusted rate of return. All of these estimates are subject to considerable uncertainty and may change materially from period to period.

Changes in Accounting Policies

Effective for the year ending December 31, 2004, the Corporation adopted the recommendations of the Canadian Institute of Chartered Accountants (CICA) Handbook Section 3110, "Asset Retirement Obligations". Under this Section, future obligations to retire an asset, including dismantling, remediation and ongoing treatment and monitoring of the site, are recognized and recorded as a liability at fair value as at the time the asset is acquired or the event occurs giving rise to such an obligation. The liability is accreted over time through periodic charges to earnings. The corresponding asset retirement cost is capitalized as part of the asset's carrying value, and is amortized over the asset's useful life in accordance with the Corporation's property, plant and equipment amortization policies. Previously, the Corporation provided for estimated reclamation, site restoration and other closure costs using the units-of-production method based upon the applicable asset usage or mine plan commencing when a reasonably accurate estimate of the cost could be made. This change in accounting policy has been adopted retroactively, resulting in an increase in long-term liability of \$450,226 and an increase to property, plant and equipment of \$174,835 as at December 31, 2003, a reduction of reported earnings for 2003 of \$44,993 and a decrease to opening retained earnings for 2003 of \$230,398.

Also effective for the Corporation's 2004 fiscal year, the CICA Handbook has been confirmed as the primary source of Canadian GAAP, with secondary sources including International Accounting Standards and US GAAP. Industry practice is no longer considered a valid source of GAAP. The Corporation is therefore now including amortization and depletion charges in the cost of inventory. Previously, amortization and depletion were charged directly to earnings. The new policy does not affect reported earnings in any prior year as it requires the change to be implemented prospectively at the start of the Corporation's 2004 fiscal year. As of December 31, 2004, the Corporation has included \$70,925 of amortization and depletion in the cost of its coal inventories. Also as a consequence of this change, amortization and depletion applicable to production sold during a year has been reclassified for presentation purposes in the statement of operations to production cost of coal sold, and this reclassification has been effected retroactively.

Where applicable, the figures disclosed in this MD&A have been restated for the effect of the above-described changes.

In June 2003, the CICA issued a new Accounting Guideline #15, Consolidation of Variable Interest Entities, subsequently revised in August 2004. The effect of this guideline is to require the Corporation to consolidate any entity where the Corporation expects to receive or absorb the majority of the entity's expected losses, expected residual returns, or both. The Corporation will be required to adopt the provisions of this guideline commencing with the first quarter of 2005. The Corporation does not believe that this guideline will have a significant effect on its financial statements.

Use of Financial Instruments

The Corporation does not hedge the price of its coal, nor has the Corporation employed hedge accounting in either 2004 or 2003. The Corporation may use certain derivative instruments to manage its exposure to foreign currency fluctuations, though no such derivative instruments were outstanding as at December 31, 2004 or 2003. The Corporation's use of such derivative instruments generally is not regular and is not believed to have a material impact on the underlying financial results of the Corporation.

Contingency

In 2002, the Corporation entered into an agreement to acquire a company with certain coal resource properties and equipment. Under the terms of the agreement, the Corporation issued 682,680 shares into escrow pending the satisfaction of certain conditions. Those conditions were not satisfied, and the agreement was terminated. The vendors dispute that the conditions were not or could not be satisfied, and have filed a claim against the Corporation for damages of \$21 million plus certain costs. The shares remain in escrow pending resolution of the claim. The Corporation considers this claim to be without merit and is defending it vigorously, and a writ of defense has been filed in the Court of Queen's Bench of Alberta. No provision has been recorded in the financial statements in respect of this claim.

Miscellaneous Information

As at this date, the Corporation has 42,351,220 shares outstanding, of which 682,680 are held in escrow and are subject to dispute. In addition, there are 797,500 share purchase warrants and 1,402,500 stock options outstanding.

Additional information relating to the Corporation is available on SEDAR at www.sedar.com. The Corporation has filed its Annual Information Form in respect of the 2003 fiscal year on SEDAR, and intends to file an Annual Information Form in respect of its 2004 fiscal year on SEDAR as well.



David J. Slater
President and Chief Executive Officer

March 23, 2005



**Consolidated Financial Statements
for the year ended December 31, 2004**

To the Shareholders of Hillsborough Resources Limited

The accompanying consolidated financial statements of the Corporation were prepared by management in accordance with accounting principles generally accepted in Canada, and within the framework of the summary of significant accounting policies in the notes to these financial statements. Management is responsible for all information in the Annual Report. All financial and operating data in the Annual Report is consistent, where appropriate, with that contained in the consolidated financial statements.

A system of accounting and control is maintained in order to provide reasonable assurance that the assets are safeguarded and that transactions are properly recorded and executed in accordance with management's authorization. The system includes established policies and procedures, the selection and training of qualified persons as is reasonably possible, and an organization providing for the appropriate delegation of authority and segregation of responsibilities for a Corporation of the size of Hillsborough Resources Limited.

The Board of Directors discharges its responsibilities for the consolidated financial statements primarily through the activities of its Audit Committee. This Committee meets with management and the Corporation's independent auditors to assure that it is performing its responsibility to maintain financial controls and systems and to approve all financial information released to the public. The Audit Committee also meets with the independent auditors to discuss the scope and the results of the audit and the audit report prior to submitting the financial statements to the Board of Directors for approval.

The consolidated financial statements for 2004 and 2003 have been audited on behalf of the shareholders by the Corporation's independent auditors, PricewaterhouseCoopers LLP, in accordance with Canadian generally accepted auditing standards. The auditors' report outlines the scope of their audit and their opinion on these consolidated financial statements.



David J. Slater
President and Chief Executive Officer

March 23, 2005



David E. Whittle
Chief Financial Officer

To the Shareholders of Hillsborough Resources Limited

We have audited the consolidated balance sheets of Hillsborough Resources Limited as at December 31, 2004 and 2003 and the consolidated statements of operations and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 2004 and 2003 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

Chartered Accountants

Vancouver, British Columbia

March 3, 2005

except as to note 18 which is as of March 23, 2005

**CONSOLIDATED BALANCE SHEETS
AS AT DECEMBER 31**

	2004	2003
		As Restated (see note 2(g))
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 6,903,589	\$ 1,380,514
Marketable securities	21,432	30,362
Receivables	2,145,318	1,340,423
Inventories (see note 3)	1,814,520	4,534,337
Prepaid expenses and deposits	316,068	291,019
Assets held for sale	56,194	118,606
	11,257,121	7,695,261
Property, Plant and Equipment (see note 4)	14,956,399	7,691,370
Deposits and Deferred Charges (see note 5)	1,080,972	1,598,154
	\$ 27,294,492	\$ 16,984,785
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Accounts payable and accrued liabilities	\$ 2,246,189	\$ 1,526,886
Income and resource taxes payable	44,921	6,892
Current portion of loans and lease obligations	–	18,127
	2,291,110	1,551,905
Asset Retirement Obligation (see note 6)	1,092,896	737,689
	3,384,006	2,289,594
Shareholders' Equity		
Share capital (see note 7)	19,432,320	12,247,043
Warrants (see note 8)	351,000	200,000
Contributed surplus	1,713,593	1,713,593
Stock options (see note 9)	69,294	1,332
Retained earnings	2,344,279	533,223
	23,910,486	14,695,191
	\$ 27,294,492	\$ 16,984,785

COMMITMENTS (see note 13)

CONTINGENCIES (see note 14)

SUBSEQUENT EVENTS (see note 18)

APPROVED ON BEHALF OF THE BOARD OF DIRECTORS

Winston D. Stothert, Director

George W. Stuart, Director

The accompanying notes are an integral part of these consolidated financial statements

**CONSOLIDATED STATEMENTS OF OPERATIONS AND RETAINED EARNINGS
 FOR THE YEAR ENDED DECEMBER 31**

	2004	2003
		As Restated (see note 2(g))
Coal Revenues	\$ 23,395,086	\$ 13,467,011
Production Cost of Coal Sold	19,228,455	11,462,720
Contribution from Sales	4,166,631	2,004,291
Operating Expenses		
Accretion of asset retirement obligation	62,235	45,023
Amortization of general and administrative assets	32,256	29,091
Selling, general and administrative	2,026,179	1,692,686
	2,120,670	1,766,800
Earnings from Operations	2,045,961	237,491
Other Income (Expenses)		
Write-down of property, plant and equipment (see note 4)	(346,030)	(7,184)
Write-down of marketable securities	(8,930)	(41,079)
Reversal of unsecured creditor liabilities (see note 10)	–	682,557
Other income and expenses, net (see note 10)	206,209	50,692
Earnings Before Provision for Taxes	1,897,210	922,477
Provision for Taxes — current (see note 11)	86,154	48,141
Net Earnings	1,811,056	874,336
Retained Earnings (Deficit) — Beginning of Year, As Previously Reported	808,614	(110,715)
Adjustment on adoption of new accounting standards pertaining to asset retirement obligations (see note 2(g))	(275,391)	(230,398)
Retained Earnings (Deficit) — Beginning of Year, As Restated on Adoption of New Accounting Standards	533,223	(341,113)
Retained Earnings — End of Year	\$ 2,344,279	\$ 533,223
Earnings Per Share (see note 12)		
Basic	\$ 0.06	\$ 0.03
Diluted	\$ 0.05	\$ 0.03

The accompanying notes are an integral part of these consolidated financial statements

**CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31**

	2004	2003
	As Restated (see note 2(g))	
Cash Flows from Operating Activities		
Net earnings	\$ 1,811,056	\$ 874,336
Items not affecting cash from operations —		
Accretion of asset retirement obligation	62,235	45,023
Amortization and depletion	994,065	643,906
Stock based compensation expense	87,709	1,332
Non-cash financing charges	24,986	—
Write-down of property, plant and equipment	346,030	7,184
Write-down of marketable securities	8,930	41,079
Reversal of unsecured creditor liabilities	—	(682,557)
(Gain) loss on disposition of property, plant and equipment, net	(42,369)	1,308
	3,292,642	931,611
Net changes in non-cash working capital balances related to operations (see note 17)	2,709,614	(1,469,472)
	6,002,256	(537,861)
Cash Flows from Investing Activities		
Purchase of property, plant and equipment	(8,184,111)	(1,446,654)
Proceeds from disposition of property, plant and equipment	47,903	—
Change in reclamation deposits and deferred charges	515,610	169,333
	(7,620,598)	(1,277,321)
Cash Flows from Financing Activities		
Repayment of loans and lease obligations	(18,127)	18,127
Common shares issued under private placement	6,152,745	—
Common shares issued on exercise of warrants	899,899	—
Common shares issued on exercise of stock options	106,900	—
	7,141,417	(18,127)
Net Cash Flows	5,523,075	3,177,569
Cash and Cash Equivalents – Beginning of Year	1,380,514	(1,797,055)
Cash and Cash Equivalents – End of Year	\$ 6,903,589	\$ 1,380,514

SUPPLEMENTAL INFORMATION

**Cash Flows Arising From Interest Paid and Received
and Income and Resource Taxes Paid**

Interest received	\$ 49,000	\$ 69,000
Interest paid	\$ 16,000	\$ 19,000
Income and resource taxes paid	\$ 55,000	\$ 56,000

1. Nature of Operations

The Corporation's business comprises the operation of coal mines, the development of new coal resources and the development of opportunities related generally to coal and industrial minerals. The Corporation's coal interests are targeted to both the thermal and coking coal markets. The Corporation's principal subsidiary is Quinsam Coal Corporation, which operates the Quinsam coal mine on Vancouver Island, British Columbia. The Corporation has additional coal interests under development in British Columbia, and in February 2005 acquired a coal property located in Tennessee on which the Corporation is commencing the process of bringing an underground coal mine into operation.

2. Significant Accounting Policies

(a) Basis of Consolidation and Financial Statement Preparation

These consolidated financial statements include the accounts of the Corporation and all of its subsidiaries.

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"), and are reported in Canadian dollars.

(b) Use of Estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts and the valuation of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the period reported.

Significant areas requiring the use of management's judgement include evaluating the carrying values of property, plant and equipment, determining amortization rates, determining coal reserves and resources, estimating future income tax assets and liabilities, estimating asset retirement obligations including future environmental obligations and site restoration costs and determining the value of stock-based compensation. By their nature, such estimates are subject to measurement uncertainty. Actual results could differ, and such estimates may be subject to change in the future.

(c) Cash and Cash Equivalents

Cash and cash equivalents comprise cash on hand, demand deposits, term deposits and guaranteed investment certificates that mature within three months or less from the date of purchase and can readily be liquidated to known amounts of cash.

(d) Marketable Securities

Marketable securities are recorded at the lower of cost and fair market value.

(e) Inventories

Coal inventories, including raw and clean coal, are valued at the lower of average cost and net realizable value. The cost of coal inventory includes direct costs of production as well as such overhead and amortization and depletion costs as are applicable to production.

Supplies inventory is valued at the lower of average cost and net realizable value.

Effective for the Corporation's 2004 fiscal year, the Canadian Institute of Chartered Accountants (CICA) Handbook has been confirmed as the primary source of Canadian GAAP, with secondary sources including International Accounting Standards and US GAAP. Industry practice is no longer considered a valid source of GAAP. The Corporation is therefore now including amortization and depletion charges in the cost of inventory. Previously, amortization and depletion were charged directly to earnings. The new policy does not affect reported income in any prior year as it requires the change to be implemented prospectively at the start of the Corporation's 2004 fiscal year. As of December 31, 2004, the Corporation has included

\$70,925 of amortization and depletion in the cost of its coal inventories. Also as a consequence of this change, amortization and depletion applicable to production sold during a year has been reclassified for presentation purposes in the statement of operations to production cost of coal sold, and this reclassification has been effected retroactively.

(f) Property, Plant and Equipment

Plant and equipment is recorded at cost less accumulated amortization and write-downs. Amortization for plant assets that are incorporated into mine operations is provided on the straight-line method based on the estimated useful lives of the assets according to the current mine plan. Amortization for equipment and other plant assets is generally provided on the declining balance method based on the estimated useful lives of the assets. These amortization rates by principal asset class are as follows:

Buildings	5%
Equipment	30% to 50%
Furniture and fixtures	20%
Middle Point barge facility	20 years

Mine properties are properties which are either in production or for which the decision has been taken to bring the property into production and construction has commenced. Resource properties are properties under exploration and development. Investments in mine and resource properties are recorded at cost. All costs of acquiring such properties are capitalized, including any related financing or interest costs, and the costs of exploration and mine development activities thereon are deferred on a project basis. When a property is put into commercial production, the capitalized acquisition, exploration and mine development costs are amortized on the units of production method. If a mine or resource property is abandoned, the carrying amount is written down to its estimated recoverable amount. The recovery of the carrying amount of a resource property in the pre-commercial production stage is dependent upon the development of economically recoverable reserves, future profitable production or the proceeds from its disposition.

The Corporation performs impairment tests periodically on its property, plant and equipment assets which compare expected undiscounted future cash flows from these assets to their carrying amounts. If shortfalls exist, assets are written down to the discounted value of the future cash flows.

(g) Asset Retirement Obligation

Effective for the year ending December 31, 2004, the Corporation has adopted the recommendations of the CICA Handbook Section 3110, "Asset Retirement Obligations". Under this Section, future obligations to retire an asset, including dismantling, remediation and ongoing treatment and monitoring of the site, are recognized and recorded as a liability at fair value as at the time the asset is acquired or the event occurs giving rise to such an obligation. The liability is accreted over time through periodic charges to earnings. The corresponding asset retirement cost is capitalized as part of the asset's carrying value, and is amortized over the asset's useful life in accordance with the Corporation's property, plant and equipment amortization policies.

Previously, the Corporation provided for estimated reclamation, site restoration and other closure costs using the units-of-production method based upon the applicable asset usage or mine plan commencing when a reasonably accurate estimate of the cost could be made. This change in accounting policy has been adopted retroactively, resulting in an increase in long-term liability of \$450,226 and an increase to property, plant and equipment of \$174,835 as at December 31, 2003, a reduction of reported income for 2003 of \$44,993 and a decrease to opening retained earnings for 2003 of \$230,398.

(h) Revenue Recognition

Revenue from the sale of coal is recognized when there is a contractual agreement for the sale of coal and the coal has been delivered under the terms of that agreement such that the risk and title of ownership of the coal has passed to the customer. Recognition of any revenue is subject to the provision that ultimate collection be reasonably assured at the time of recognition.

(i) Stock-Based Compensation Plans

The Corporation accounts for its stock-based compensation plans in accordance with the recommendations of CICA Handbook Section 3870, "Stock-Based Compensation and Other Stock-Based Payments", which requires the fair value based method of accounting for all stock-based compensation earned during the year. Under this method, the fair value of options granted to employees is estimated on the date of grant and is recognized as compensation expense over the vesting period of the options. Consideration paid on exercise of stock options is credited to share capital.

(j) Income Taxes

The Corporation follows the asset and liability method of tax allocation accounting. Under this method, current income taxes are recognized for the estimated income taxes payable for the current year. Future tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantial enactment. The amount of future income tax assets recognized is limited to the amount that is estimated as more likely than not to be realized.

(k) Translation of Foreign Currencies

The Corporation's functional currency, or unit of measure, is the Canadian dollar. Transactions in foreign currencies are translated into Canadian dollars at either actual or estimated exchange rates in effect on the transaction date. Monetary assets and liabilities expressed in foreign currencies are translated into Canadian dollars at the exchange rates in effect at the balance sheet date. The resulting exchange gains and losses are recognized in income.

(l) Derivative Transactions

The Corporation does not hedge the price of its coal sales. Some coal contracts are denominated in currency other than the Canadian dollar. The Corporation may enter into foreign exchange contracts to mitigate the exposure to exchange rate changes on these anticipated sales. Gains or losses from such foreign exchange contracts are reported in Other Income or Expenses as they are not specifically identified as foreign currency hedges.

(m) Earnings Per Share

Earnings per share are calculated using the weighted average number of shares outstanding. The treasury stock method is used to calculate the dilutive effect of options, warrants and similar instruments. Under this method, dilution is calculated based upon the net number of shares issued assuming "in-the-money" instruments are exercised and the proceeds are used to repurchase issued and outstanding common shares at the weighted average trading price for the period.

(n) Comparative Information

Certain of the comparative figures have been reclassified to conform with the current period's presentation format.

3. Inventories

	2004	2003
Coal inventory	\$ 1,245,052	\$ 3,945,054
Supplies inventory	569,468	589,283
	\$ 1,814,520	\$ 4,534,337

4. Property, Plant and Equipment

	Cost	Accumulated Amortization, Depletion and Write-Downs	2004 Net
Land	\$ 1,699,375	\$ —	\$ 1,699,375
Plant and equipment	44,529,363	33,820,489	10,708,874
Furniture, fixtures and other	608,475	560,687	47,788
Mine property and development costs	1,972,568	386,711	1,585,857
Resource property and exploration costs	914,505	—	914,505
	\$ 49,724,286	\$ 34,767,887	\$ 14,956,399

	Cost	Accumulated Amortization, Depletion and Write-Downs	2003 Net
Land	\$ 1,550,026	\$ —	\$ 1,550,026
Plant and equipment	37,490,889	33,070,126	4,420,763
Furniture, fixtures and other	586,613	528,431	58,182
Quinsam power plant project	342,819	—	342,819
Mine property and development costs	1,056,356	184,674	871,682
Resource property and exploration costs	447,898	—	447,898
	\$ 41,474,601	\$ 33,783,231	\$ 7,691,370

During the year ended December 31, 2004, the Corporation acquired the Middle Point barge facility located near the Quinsam coal mine on Vancouver Island, British Columbia, through which the majority of the Quinsam mine production has historically been shipped. The Corporation acquired the facility for \$3,695,509, of which \$3,518,776 is recorded in plant and equipment and \$176,733 is recorded in land.

Included in plant and equipment at December 31, 2004 is \$339,794 paid in advance in respect of an acquisition of certain Tennessee mining assets that was completed subsequent to the end of the year (see note 18(b)).

During the year ended December 31, 2004, the Corporation wrote off its investment in the Quinsam power plant project and consequently recorded a charge of \$346,030.

During the year ended December 31, 2004, the Corporation entered into an option agreement to acquire a 100% interest in the Bingay Creek property, a coking coal property located in the Elk Valley region of Southeast British Columbia. Under the terms of the agreement, the Corporation has paid \$120,000 to the optionors during

2004, and must incur a minimum of \$500,000 in exploration and development expenditures in respect of the property by August 1, 2007. The optionors have been granted royalties in respect of washed coal ranging from \$1 to \$2.75 per tonne sold and royalties in respect of raw coal ranging from 2% to 4% of sale proceeds, depending on the type of coal and the area of the property from which it is produced. One of the optionors is, and was at the time the agreement was entered into, an employee of the Corporation. Expenditures pertaining to this property have been included in resource property and exploration costs.

5. Deposits and Deferred Charges

	2004	2003
Deposits	\$ 993,000	\$ 1,494,000
Deferred charges	87,972	104,154
	\$ 1,080,972	\$ 1,598,154

Deposits primarily consist of interest bearing funds deposited with financial institutions as security for reclamation and environmental obligations, mining permits and other business related activities.

6. Asset Retirement Obligation

	2004	2003
Asset retirement obligation — beginning of year	\$ 737,689	\$ 692,666
Obligations incurred during the year	292,972	—
Accretion expense	62,235	45,023
Asset retirement obligation — end of year	\$ 1,092,896	\$ 737,689

The Corporation's asset retirement obligation arises from its obligations to undertake site reclamation and remediation in connection with its operating activities. The deposits which the Corporation has in place to secure these obligations have a fair value of approximately \$993,000 and are included in Deposits and Deferred Charges (see note 5).

The total undiscounted amount of the estimated cash flows required to settle the asset retirement obligation is estimated to be \$1,782,000 measured in 2004 dollars. While some expenditures will be incurred during the operating lives of the underlying assets to which they relate, a significant component of these cash flows will be expended towards the end of their lives, generally between 10 and 20 years in the future. In determining the carrying value of the asset retirement obligation, the Corporation has assumed a credit-adjusted risk-free discount rate of 6.5% and a long-term inflation rate of 2.5%.

7. Share Capital

Authorized:

Unlimited number of common shares, without par value

Issued and Outstanding	Number of shares	Amount
Balance — December 31, 2002	29,681,728	\$ 12,205,483
Adjustment for issuer bid	—	41,560
Correction for rounding of fractional shares	63	—
 Balance — December 31, 2003	 29,681,791	 12,247,043
Exercise of stock options	287,500	108,232
Exercise of warrants	2,499,720	1,024,885
Issued pursuant to Employee Share Purchase Plan	26,159	18,415
Private placement	7,000,000	6,033,745
Balance — December 31, 2004	39,495,170	\$ 19,432,320

Effective December 30, 2004, the Corporation issued on a private placement basis 5,000,000 shares at a price of \$0.90 each and 2,000,000 flow-through shares at a price of \$1.05, for gross proceeds of \$6,600,000. The agents to the private placement were paid a commission of 5.5% and received brokers' warrants to acquire 350,000 shares at any time until December 30, 2005 at a price of \$0.99 per share. After deducting the agents' commission of \$363,000, the fair value of the brokers' warrants granted of \$119,000 and other issuance expenses of \$84,255, net proceeds from the issuance were \$6,033,745.

8. Warrants

	Number of shares issuable on exercise	Weighted average exercise price	Carrying Amount
Balance — December 31, 2003 and 2002	4,499,720	\$0.36	\$ 200,000
Issued on asset acquisition (see below)	400,000	\$0.54	132,000
Issue of brokers' warrants (see note 7)	350,000	\$0.99	119,000
Exercised	(2,499,720)	\$0.36	(100,000)
Balance — December 31, 2004	2,750,000	\$0.47	\$ 351,000

During 2004, as part of the consideration paid to acquire the Middle Point barge facility (see note 4), the Corporation issued warrants to the vendor to acquire 400,000 shares at a price of \$0.54 each with a five year term. The fair value of these warrants was estimated to be \$132,000 and is included in the cost of the facility acquired.

Warrants outstanding at December 31, 2004 expire between October 6, 2006 and April 1, 2009.

9. Stock-Based Compensation Plans

The Corporation has one incentive stock option plan, as well as an employee share purchase plan.

Under the employee share purchase plan, which was implemented during 2004, an employee can elect to have an amount deducted from his or her pay which is then accumulated and, on a quarterly basis, used to acquire shares of the Corporation from treasury at the market price applicable at the end of the quarter. The Corporation effectively matches 50% of the employee's contribution by issuing additional top-up shares. The value of the top-up shares so issued during 2004 was \$18,415 and is included in stock-based compensation expense.

Under the stock option plan and at the discretion of the board of directors, the Corporation may grant incentive stock options and stock appreciation rights to directors, officers, employees and consultants. The maximum term of options granted under this plan is ten years, and the exercise price is determined at the discretion of the Directors of the Corporation subject to the provision that it not be less than the market price of the common shares at the date of granting. Options vest either immediately or within 24 months, as determined by the Directors on granting. The number of common shares issuable on exercise of stock options granted under this plan cannot exceed 3,400,000.

During the years ended December 31, 2003 and December 31, 2004, incentive stock options were granted and exercised as follows:

	Number of shares issuable on exercise	Weighted average exercise price
Balance — December 31, 2002	1,998,000	\$0.42
Granted	10,000	\$0.27
Forfeited	(56,500)	\$0.90
Balance — December 31, 2003	1,951,500	\$0.41
Granted	250,000	\$0.70
Exercised	(287,500)	\$0.37
Forfeited	(76,500)	\$0.85
Balance — December 31, 2004	1,837,500	\$0.43

All options granted during 2004 and 2003 carried exercise prices equal to the fair value of the common shares as at the granting date. The weighted average per-share fair value of options granted during 2004 was \$0.32 (2003 – \$0.13), and the stock-based compensation expense recognized for the year in respect of options granted was \$69,294 (2003 – \$1,332).

The fair value of the options at the date of grant was estimated using the Black-Scholes option pricing model, assuming a risk-free interest rate of 5% per annum, an expected life of options of approximately 2 years, an expected volatility of between 60% and 65% and no dividends (2003 – 4.3%, 3.28 years, 67% and no dividends, respectively).

Incentive stock options outstanding at December 31, 2004 are summarized as follows:

Exercise Price	Options Outstanding			Options Exercisable		
	Number of Shares Issuable on Exercise	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price	Number of Shares Issuable on Exercise	Weighted Average Exercise Price	
\$0.00 to \$0.09	200,000	5	\$0.07	200,000	\$0.07	
\$0.10 to \$0.19	350,000	5	\$0.10	350,000	\$0.10	
\$0.30 to \$0.39	480,000	7	\$0.35	480,000	\$0.35	
\$0.50 to \$0.59	337,500	8	\$0.53	337,500	\$0.53	
\$0.60 to \$0.69	10,000	7	\$0.60	10,000	\$0.60	
\$0.70 to \$0.79	217,500	10	\$0.70	85,000	\$0.70	
\$0.90 to \$0.99	20,000	7	\$0.97	20,000	\$0.97	
\$1.00	222,500	4	\$1.00	222,500	\$1.00	
	1,837,500	7	\$0.43	1,705,000	\$0.41	

10. Other Income and Expenses

	2004	2003
Interest income	\$ 47,550	\$ 67,539
Interest expense	(50,759)	(19,088)
Foreign exchange loss	(136,515)	(63,610)
Gain (loss) on disposition of property, plant and equipment	42,369	(1,308)
Gain on disposition of supplies inventory	35,000	–
Gain on disposition of assets held for sale	316,320	–
Rental income	–	67,635
Corporate restructuring	–	(60,740)
Miscellaneous	(47,756)	60,264
	\$ 206,209	\$ 50,692

During the year ended December 31, 2003, the Corporation recorded a gain of \$682,557 from the reversal of unsecured creditor liabilities of a subsidiary.

11. Income Taxes

The amount recorded as a provision for current taxes for the years ended December 31, 2004 and 2003 is in respect of resource taxes, and with respect to 2003 federal large corporations tax, incurred during the year.

The following table reconciles the income and resource taxes that would be incurred by applying statutory tax rates to the Corporation's pre-tax income and the taxes actually recorded:

	2004	2003
Income before provision for taxes	\$ 1,897,210	\$ 922,477
Statutory tax rates	36%	38%
Income taxes at statutory tax rates	682,996	350,541
Non-deductible permanent differences	49,465	(23,719)
Tax benefits not previously recognized	(571,591)	(322,594)
Resource allowance	(160,870)	(4,228)
Resource and large corporations taxes	86,154	48,141
Provision for taxes	\$ 86,154	\$ 48,141

The Corporation has available non-capital losses for income tax purposes of approximately \$3,298,000 (2003 – \$3,185,000), which are available to be carried forward to reduce taxable income in future years, and expire as follows:

2005	\$ 12,000
2006	15,000
2007	1,663,000
2008	4,000
2009	1,026,000
2010	574,000
2014	4,000
	\$ 3,298,000

Net temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases deductible against taxable income of future years, including non-capital losses, total approximately \$56.5 million. The after-tax amount of future income tax assets arising from these temporary differences are summarized as follows:

	2004	2003
Tax loss carry forwards and other amounts	\$ 1,385,017	\$ 1,483,889
Tax values of assets in excess of carrying values	18,379,788	17,084,068
Carrying values of liabilities in excess of tax values	393,443	–
Future income tax assets	20,158,248	18,567,957
Valuation allowance	(20,158,248)	(18,567,957)
	\$ –	\$ –

12. Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share:

	2004	2003
Numerator		
Net income	\$ 1,811,056	\$ 874,336
Denominator		
Denominator for basic earnings per share —		
Weighted average number of shares outstanding	31,949,150	29,681,752
Effect of dilutive securities —		
Stock options	837,264	466,765
Warrants	1,135,135	—
Denominator for diluted earnings per share —		
Adjusted weighted average number of shares outstanding	33,921,549	30,148,517
Basic earnings per share	\$0.06	\$0.03
Diluted earnings per share	\$0.05	\$0.03

Stock options to acquire 480,000 shares (2003 – 1,141,500 shares) and warrants to acquire 350,000 shares (2003 – 4,499,720 shares) were outstanding at December 31, 2004 but were not included in the computation of diluted earnings per share because their exercise price was greater than the average market price of the Corporation's shares during the year.

13. Commitments

The Corporation leases certain equipment and office premises under operating leases. The future minimum payments under these leases are as follows:

2005	\$ 287,592
2006	74,657
2007	17,374
2008	5,853
	\$ 385,476

14. Contingencies

In 2002, the Corporation entered into an agreement to acquire a company with certain coal resource properties and equipment. Under the terms of the agreement, the Corporation issued 682,680 shares into escrow pending the satisfaction of certain conditions. Those conditions were not satisfied, and the agreement was terminated. The vendors dispute that the conditions were not or could not be satisfied, and have filed a claim against the Corporation for damages of \$21 million plus certain costs. The shares remain in escrow pending resolution of the claim. The Corporation considers this claim to be without merit and is defending it vigorously. No provision has been recorded in the financial statements in respect of this claim.

15. Related Party Transactions

In 2004, a total of \$383,560 (2003 – \$289,447) was paid to two companies which are related to different directors of the Corporation. The payments were made for legal services and for coal trucking and aggregate crushing services.

Other related party transactions are disclosed elsewhere in these financial statements.

16. Financial Instruments and Concentration of Risk

Fair Values

The Corporation's financial instruments include cash and cash equivalents, marketable securities, receivables, deposits, accounts payable and accrued liabilities and income and resource taxes payable. The fair values of these financial instruments approximate their carrying values.

Credit Risk

The Corporation maintains substantially all of its cash and cash equivalents with major financial institutions in Canada and the United States. Financial instruments that potentially subject the Corporation to concentration of credit risk are primarily receivables. Management is of the opinion that any risk of loss is significantly reduced due to the financial strength of the Corporation's major customers.

Foreign Currency Risk

A significant component of the Corporation's transactions are undertaken in US dollars, and the company maintains significant deposits in US dollar denominated accounts. Fluctuations in exchange rates between the Canadian and US dollar could have a material effect on the business, results of operations and financial condition of the Corporation. The Corporation may sometimes use derivative instruments to manage its exposure to foreign currency exchange risk. The Corporation had no foreign currency derivatives outstanding at December 31, 2004 or 2003.

17. Net Change in Non-Cash Working Capital Balances

The components of the net change in non-cash working capital balances related to operations are as follows:

	2004	2003
Receivables	\$ (804,895)	\$ 67,236
Inventories	2,719,817	(782,701)
Prepaid expenses and deposits	(25,049)	(159,704)
Assets held for sale	62,412	(114)
Accounts payable and accrued liabilities	719,300	(583,565)
Income and resource taxes payable	38,029	(10,624)
Increase (decrease)	\$ 2,709,614	\$ (1,469,472)

18. Subsequent Events

As of March 23, 2005, the following significant events have occurred subsequent to December 31, 2004.

(a) Share Capital

Subsequent to December 31, 2004, an additional 2,252,500 shares have been issued for total proceeds of \$879,975 upon the exercise of warrants, an additional 585,000 shares have been issued for total proceeds of \$93,950 upon the exercise of stock options and an additional 18,550 shares have been issued for \$22,186 under the employee share purchase plan. Also subsequent to December 31, 2004, the Corporation has granted additional options under its stock option plan to acquire a total of 450,000 shares at a prices ranging from \$1.28 to \$1.71.

(b) Acquisition of Tennessee Mining Assets

Effective February 10, 2005, the Corporation acquired certain coal leases and mining assets and assumed certain associated liabilities located near Crossville, Tennessee. The assets were acquired from a vendor who formerly operated a surface coal mine on the property, and the Corporation is now commencing the process of bringing an underground coal mine into operation on the property. The assigned values of the assets acquired and liabilities assumed, and the consideration paid, are summarized as follows:

Assigned values of assets and liabilities assumed:

Surface mining equipment	\$ 2,685,636
Coal preparation plant and other equipment	2,027,224
Liabilities assumed	(2,153,709)
Permit bonding guarantee assumed	(1,220,275)
	\$ 1,338,876

Consideration paid:

Cash paid	\$ 1,056,379
Fair value of warrants granted	183,000
Costs incurred in completing the acquisition of the assets	99,497
	\$ 1,338,876

The assigned values of the surface mining equipment acquired and the liabilities and permit bonding guarantee assumed are their estimated fair values. The in-use value of the coal preparation plant as appraised by a third party and other equipment acquired as estimated by the Corporation is approximately \$3,478,000. However, the Corporation has assigned a carrying value to the coal preparation plant and other equipment of \$2,027,224 given that the value of the consideration paid is less than the value of the assets acquired net of the liabilities assumed.

As part of the consideration paid, the Corporation has issued warrants to acquire 300,000 shares at an exercise price of \$1.77, expiring February 8, 2007. The fair value of these warrants was estimated to be \$183,000. Included in the cash paid was \$339,794 that had been paid as of December 31, 2004 in advance of the acquisition of the assets, and this amount has been included in the Corporation's plant and equipment reported in note 4.

The Corporation has granted a royalty to the vendor of US \$0.50 per short ton of coal sold. A second royalty of US \$0.10 per short ton of coal sold has been granted to a third party, which royalty is extinguished once an aggregate US \$75,000 has been paid under it.

Immediately subsequent to its acquisition by the Corporation, the surface mining equipment was sold to a third party purchaser for proceeds of \$2,685,636, of which \$1,517,554 was immediately applied against certain of the assumed liabilities.

(c) Acquisition of Northeast British Columbia Resource Properties

In January 2005, the Corporation entered into a letter of intent to acquire a group of coal resource properties located in Northeast British Columbia near Tumbler Ridge, and in March 2005 the final terms of the transaction were agreed and the acquisition was closed. The group includes 11 properties, eight of which are coking coal properties, two of which are coking and PCI (pulverized coal injection) properties and one of which is a thermal coal property. The consideration to be paid for the properties by the Corporation comprises a mixture of cash and shares, with \$400,000 paid on closing and the remaining consideration paid over time upon the achievement of various milestones in the development of the properties. The remaining consideration is summarized as follows:

- (i) With respect to the Five Cabin property, a coking coal property, 800,000 shares upon the preparation of a coal resource estimate report; \$500,000 and 1,000,000 shares upon preparation of a pre-feasibility report; \$500,000 and 1,000,000 shares upon preparation of a feasibility study; and \$1,000,000 and 1,500,000 shares upon commencement of commercial production from the property.
- (ii) With respect to each of seven additional coking coal and PCI properties, shares issuable upon preparation of a coal resource estimate report and upon preparation of a pre-feasibility study in respect of the property, ranging from 4,000 to 5,000 shares per 100,000 tonnes of coal resource identified, with a minimum 10 million tonnes of resource required to trigger consideration payment.
- (iii) For the one thermal coal property, the Corporation must issue 225,000 shares on delivery of a coal resource estimate report and a further 625,000 shares on preparation of a pre-feasibility study, and an additional 1,250 shares for each 100,000 tonnes of resource identified in excess of 20 million tonnes.
- (iv) For one coking coal and PCI property, shares issuable upon preparation of a coal resource estimate report and upon preparation of a pre-feasibility study in respect of the property, ranging from 3,000 to 5,000 shares per 100,000 tonnes of coal resource identified depending on whether the resource is coking coal or PCI or thermal coal, with a minimum 5 million tonnes of resource required to trigger consideration payment.

Various time limits apply within which the Corporation must achieve the set milestones, but the Corporation has the right to extend those time limits on a property by property basis by making certain cash payments. At all times the Corporation has the right to deliver any of the properties back to the vendor, in which case no further consideration or milestone obligations will be owing by the Corporation in respect of such property. All properties are subject to a 1% mine-gate royalty in favour of the vendor.

Upon closing of the acquisition of these properties, the primary vendor has been hired by the Corporation in a senior management capacity.

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David J. Slater

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The Toronto Stock Exchange

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